Taxing Times

May 2005 – Volume 1, No. 1

T^3: *Taxing Times* Tidbits

Peter H. Winslow and Susan J. Hotine

Is the IRS Saying that Class Action Damages are not Subject to IRC section 72?

One of the significant tax benefits of a life insurance contract is that, for purposes of determining the taxable amount of proceeds received under the contract on distributions or surrender, the investment in the contract includes the aggregate amount of premiums, unreduced by the cost of insurance provided (IRC section 72(c)). In a recent Chief Counsel advice letter (CCA), the IRS seems to have ignored this basic tax rule and effectively treated a policyholder as taxable on the cost of insurance. However, the adverse result might have been avoided by a little tax planning.

In CCA 200504001 (Oct. 12, 2004), the IRS concludes that damages received from an insurance company in settlement of a class action lawsuit are includible in gross income to the extent that they exceed the policyholder's basis in the life insurance policies. However, rather than use the investment in the contract under section 72 to determine the basis and apply section 1035, the IRS used a section 1001 analysis and determined the basis for this purpose as being the premiums paid, reduced by the cost of insurance provided, as well as by amounts previously received and not included in income. In the CCA, a woman policyholder held two life insurance policies issued by the same insurance company. The first policy, which was on her former husband's life, was converted to a policy with a lower face amount (the company encouraged her to do so by erroneously saying that she would not incur any additional premiums). The second policy, on her own life, was surrendered. A class action suit was brought against the insurance company with claims that the company induced the policyholder to surrender, borrow against or otherwise withdraw values from the policies by misrepresenting the financial effect of such transactions and failing to disclose that such switches were against the policyholder's best interest. As part of the class action settlement, the policyholder was awarded damages, a portion of which was interest. The policyholder in the CCA filed a return, reporting the entire amount of damages as income and later amended her return seeking a refund, arguing that the portion of the damages in excess of interest represented the recovery of out-of-pocket expenses for premiums. The CCA concludes that the damages received by the policyholder with respect to the policy on her former husband's life (the first policy) are not includible in her gross income to the extent they exceed her "basis" in the insurance policy, as defined above. With respect to damages attributed to the policy on her own life (the second policy), the CCA concludes that all amounts are included in the policyholder's gross income because the policy was surrendered.

Ordinarily in these types of cases, the IRS looks to "the origin of the claim doctrine" to determine how the damages should be characterized. Had it done so, presumably it would have determined that the damage claims arose under the contract for life insurance and were paid in lieu of earnings the policyholder would have received under the first and second policies, if those policies had not been converted and surrendered, respectively. Under this analysis, the substitute damage payments received are treated as distributions from the life insurance policies and the IRS should have looked to section 72 and section 1035 for the tax treatment. Because the investment in the contract under section 72(c)(1) is not adjusted for the cost of insurance protection, there should have been no reduction in basis for this amount to determine the taxability of the damages received for the first policy. On the other hand, when the policyholder converted the first policy for the policy of a lower face amount, there was a tax-free exchange of policies covered by section 1035. Under section 1031(d), the basis of the new policy is the same as the first policy. With the receipt of cash damage payments, and having retained the new lower-face-amount policy, the policyholder effectively has "exchanged" the first policy for the new

Peter H. Winslow is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP. He may be reached at *pwinslow@scribnerhall.com.*

Susan J. Hotine is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP. She may be reached at *shotine@scribnerhall.com.*

policy, plus cash. In such circumstances, gain is recognized on the exchange, but not in excess of the cash plus the fair market value of the new contract (see section 1031(b)). No basis from the first policy is allocable to the cash money received (see section 1031(d)).

In damage cases like this, adverse tax consequences might be avoided with a bit of tax planning on behalf of the policyholder by the negotiators of the settlement.

In summary, if the origin of the claim is considered a payment in lieu of a distribution under the first policy, section 72 should have governed a good result. On the other hand, if the claim is considered to arise under the exchange, the basis rules of section 1031(d) should have governed a bad result. Under this section 1031(d) analysis, the analysis of the CCA may have been wrong, but it could have been worse.

The CCA cites a case and a revenue ruling as authority for how to determine the policyholder's basis. However, both the case and the ruling involved situations in which the policyholder received money in exchange for the transfer of the policy to a third party, and the amount received was less than the amount of premiums paid so that the basis was being defined for purposes of determining whether the policyholder had suffered a loss. Based on facts provided by the CCA upon the receipt of the damages, the policyholder is in a position of determining her gain on the first policy. One has to wonder if some pertinent facts are missing from the CCA's explanation, if their analysis reveals a misguided IRS plot to adopt a new approach for determining the tax treatment of damages and the amount of gain on a life insurance contract, or if the CCA was issued by a branch of the IRS that is just unfamiliar with section 72 and section 1035.

In damage cases like this, adverse tax consequences might be avoided with a bit of tax planning on behalf of the policyholder by the negotiators of the settlement. If the damages had been paid into the cash value of new lower-face-amount policy (making sure that such payment did not disqualify the contract under section 7702), the damages probably would have been considered as part of the initial tax-free exchange. The damages then could have been withdrawn from the new life insurance policy at some later time under the basis-out-first rule of section 72(e)(5)(C).

The conclusion of the CCA is that the damages received with respect to the second policy are taxable may be correct under both its erroneous analysis, and under a section 72 analysis, if the policyholder already had recovered her entire basis or investment in the contract upon surrendering the second policy. If that is not the case, the policyholder should still have had some basis to recover under section 72, unreduced by the cost of insurance.

IRS Rules Net Surrender Value Reserves must be Reduced by a YRT Reserve Credit

In TAM 200435015 (May 11, 2004), the IRS concluded that Treas. Reg. §1.801-4(a) (promulgated under the 1959 Act) has continuing applicability under present law and requires a life insurance company to reduce its life insurance reserves by the net value of the risks reinsured on a yearly renewable term (YRT) basis even if reserves are based on the net surrender value. In arriving at this conclusion, the IRS reversed its position as explained in FSA 200123024 (Mar. 7, 2001). The IRS got it right the first time.

Treas. Reg. §1.801-4(a) provides an example of YRT reinsurance with other solvent companies (whether or not authorized), and provides that life insurance reserves must be reduced for the risks reinsured. The TAM characterized the YRT example in the regulation as requiring that life insurance reserves on a contract must be reduced for a YRT reinsurance credit even if the reserves are based on the net surrender value. In the TAM, the IRS said that the addition of the net surrender value floor to the computation of federally prescribed tax reserves in section 807(d)(1) for a contract does not override the requirement in the regulation that life insurance reserves must be reduced by the net value of risks reinsured on a YRT basis; the IRS reasoned that, "because a comparison must be made to determine which is greater—the net surrender value or the Federally prescribed reserves—the net surrender value is, for this purpose, treated as a component of reserves." According to the TAM, section 807(d)(1) determines the amount of life insurance reserves for a contract, regardless of the role played by the net surrender value and, thus, Treas. Reg. §1.801-4(a) requires reduction of life insurance reserves, even

from pg. 9

though the ceding company's reserves are based on the net surrender value of the contract and the reinsurer assumes no liability with respect to the payment of the net surrender value.

The TAM's analysis is wrong for a number of reasons. Treas. Reg. §1.801-4(a) probably does have continuing applicability under the current law, but only to the extent it is interpreting provisions that are carried over from the 1959 Act. The purpose and scope of Treas. Reg. §1.801-4(a) can best be understood in the context of the requirement that, to qualify as a life insurance reserve under 816 and its predecessor, the reserve must be "required by law." The drafters of the regulation wanted to make it clear that when a ceding company continues to hold reserves with respect to reinsured risks, because state law denies reserve credit (for example, because the reinsurer is unauthorized), the portion of the reserves held by the ceding company with respect to the reinsured risks will not be included in the ceding company's life insurance reserves required by law.'" What was carried over from the 1959 Act was the "required by law" requirement for life insurance reserve qualification in section 816 and, at least in concept, the actuarially computed reserve in section 807(d)(2). Neither the definition of net surrender value in section 807(e), nor the use of the net surrender value as a floor for the actuarially computed reserve is a concept carried over from the 1959 Act. Moreover, prior to the adoption of current law tax reserve rules under the 1984 Act, the position of the IRS was that "surrender values in excess of reserves otherwise required" reported in Exhibit 8G of the Annual Statement were not life insurance reserves. Similarly, under current law, the IRS frequently has argued that changes in the computation of the net surrender value under section 807(e) are not subject to section 807(f) because the net surrender value is not a reserve item. So, if Treas. Reg. §1.801-4(a) applies to life insurance reserves, it may have little or no application to the net surrender value.

The key determination should be whether the reinsurer has assumed the risk that it will be required to reimburse the ceding company for a portion of the cash surrender value in the event of a death or surrender of the contract. If risks relating to the cash surrender value have not been reinsured, there is no reason why Treas. Reg. §1.801-4(a), or any other tax rule, should operate to reduce the ceding company's net surrender value as defined in section 807(e).

At its core, the TAM's conclusion seems to be based on the concern of the IRS is that, absent a reserve reduction for the YRT credit by the ceding company, the total amount of reserves deducted by the ceding company and the reinsurer, combined, will exceed the amount that the ceding company alone could deduct absent the reinsurance. But, this is not an unusual consequence of reinsurance when benefits that previously were covered by one contract (issued by the ceding company) become covered by two contracts (the ceding company's and the reinsurance contract). Section 807 itself contemplates that the aggregate amount of the deductible reserves may increase if the taxpayer takes steps to ensure that benefits unrelated to the net surrender value have a separate charge, so that the tax reserves for such benefits can be computed under section 807(d) and are excluded from the net surrender value comparison for the contract (e.g. the treatment of qualified supplemental benefits under section 807(e)(3)).

Undoubtedly, the position of the IRS with regard to the TAM will be challenged.